Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:WAS:RCH:TL-N-3751-01
WHenck

date:

to: Revenue Agent John Early

from: Area Counsel
(Heavy Manufacturing, Construction and Transportation:Edison)

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subject: [redacted]

This memorandum responds to your request for assistance dated May 7, 2001. This memorandum should not be cited as precedent.

ISSUE AND CONCLUSION

Issue: Whether a reverse triangular merger, in which the taxpayer is the parent corporation, qualifies as a tax free reorganization under I.R.C. § 368(a)(2)(E).

Conclusion: The reverse triangular merger qualifies under I.R.C. § 368(a)(2)(E) as a tax free reorganization with respect to the corporations involved.

FACTS

[redacted] (the taxpayer) is a real estate company in [redacted], Virginia. It had shareholders in common with [redacted], an insurance brokerage company. Both companies had a fiscal year ending [redacted]. [redacted] was an S corporation. During the taxable year ending [redacted], [redacted] agreed to merge into the taxpayer. Pursuant to a Plan and Agreement of Merger, dated [redacted], [redacted] agreed to merge into a newly created subsidiary of the taxpayer, [redacted], with [redacted] as the surviving corporation. The parties agreed to structure the transaction as a tax free reverse triangular merger under I.R.C. § 368(a)(2)(E).

[redacted] had [redacted] shares of common stock outstanding, with each of [redacted] shareholders having [redacted] shares. [redacted] had [redacted] shares of common stock outstanding, all of which were owned by the taxpayer. As part of the merger plan, the [redacted] shares of [redacted] were surrendered and canceled, the [redacted] shares of [redacted]

[redacted] were converted into [redacted] shares of [redacted] stock, and the shareholders of [redacted] received common stock of the taxpayer and cash. [redacted] was the surviving corporation in the merger, which took effect on [redacted]. Under paragraph 2.6 of the merger plan, the shareholders in [redacted] each received [redacted] shares of the taxpayer and $[redacted] in cash. In addition, the shareholders received additional consideration at the end of taxable years ending [redacted], and [redacted]. Based upon a percentage of [redacted]'s revenues in those years, the shareholders received an amount that was paid [redacted] percent in cash and the balance by issuance of shares of common stock in the taxpayer. One shareholder received the entire cash consideration and the stock was distributed [redacted] percent each to the other [redacted] shareholders and [redacted] percent to the shareholder who received the cash consideration.

DISCUSSION

A basic statutory merger can be a tax free reorganization under I.R.C. § 368(a)(1)(A). To qualify for tax free treatment, the merger must comply with general state or federal law on consolidations and must also meet the continuity of proprietary interest, continuity of business enterprise, and business purpose tests. A "reverse triangular merger" is allowed under I.R.C. § 368(a)(2)(E) if it would otherwise qualify as a statutory merger under section 368(a)(1)(A). In a reverse triangular merger, the purchasing corporation's subsidiary is merged directly into the target corporation so that the target corporation survives and the acquiring subsidiary disappears. The target corporation's shareholders exchange their stock for stock in the purchasing corporation.

Based on the information available to us, it would appear that the transaction at issue met the basic requirements under section 368(a)(1)(A). The merger meets Virginia state law requirements concerning approval by the boards of directors of both companies and the various other technical requirements. See Virginia Code § 13.1-716 et seq. The continuity of proprietary interest test is met since the shareholders in [redacted] acquired common stock in the taxpayer and the stock constituted 80 percent of the consideration. See Helvering v. Minnesota Tea Co., 296 U.S. 378 (1935). The continuity of business enterprise test is met because [redacted] will continue its historic business and do so with its historic business assets. See Treas. Reg. § 1.368-1(d)(2). Finally, the business purpose test is met since the merger plan in this case reflected a transaction "to effect a readjustment of continuing interests under modified corporate forms" rather than a bare attempt to evade tax. See Treas. Reg. § 1.368-2(g).

I.R.C. § 368(a)(2)(E) prescribes additional requirements for a reverse triangular merger to be a tax free reorganization. The target corporation ([redacted]) is required to hold substantially all of its assets and those of the acquiring subsidiary ([redacted]) after the reorganization is completed. (This does not include assets transferred from the purchasing corporation to its acquiring subsidiary to effect the reorganization.) It appears that this test is met. Under I.R.C. § 368(a)(2)(E)(ii), the shareholders in the target corporation must acquire voting stock in the purchasing corporation. This test has been met. Furthermore, the fact that some of the consideration will be paid within two years of the transaction based upon revenue does not affect the tax free treatment. Although the Service will challenge reorganizations involving contingent consideration, it will only do so in extreme situations where the transfer is very tentative. See Federal Income Taxation of Corporations and Shareholders, ¶ 12.21(7), James S. Eustice, 1998. This transaction closed on [redacted]. The additional consideration was fixed by formula and did not change the ownership of either corporation. In addition, the taxpayer assumed immediate control over [redacted]. Thus, the transaction was not tentative and certainly did not constitute an "extreme" situation. A final consideration in determining that the reorganization qualified for tax free treatment is that, under the merger plan, [redacted] did in fact cease to exist. See Rev. Rul. 2000-5, 2000-1 C.B. 436.

As a result of this transaction, both [redacted] and the taxpayer receive tax free treatment with assets retaining their historic basis. The shareholders in [redacted] receive nonrecognition treatment under section 354 with respect to the taxpayer's stock they received, but must recognize any gain from the boot (cash) under section 356. The fact that one shareholder will receive more cash and correspondingly less stock impacts on his calculation of gain under section 356, but does not affect the tax free nature of the overall transaction.

A final point is that [redacted]'s S corporation election was terminated on the date of the reorganization, [redacted], since a C corporation cannot hold stock in a S corporation under I.R.C. § 1361(b). The termination is effective on the date of the cessation of qualification and results in a short S corporation year and a short C corporation year. I.R.C. § 1362(e)(4). The shareholders in [redacted] for its short S year will receive distributable shares of income and other items for that short S year.

In conclusion, we believe that the transaction in question qualifies as a tax free reorganization under I.R.C. § 368(a)(2)(E). However, the shareholders in [redacted] must recognize any gain from the cash they received under section 356. If you have any questions, please call me at (804) 916-3946.

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By:_____
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